



**United States General Accounting Office  
Washington, DC 20548**

October 27, 2000

Mr. Charles P. Nemfakos  
Senior Civilian Official for the Office  
of the Assistant Secretary of the Navy  
(Financial Management and Comptroller)

**Subject: Financial Management: Improvements Needed in the Navy's Reporting of General Fund Inventory**

Dear Mr. Nemfakos:

As a part of our annual audit of the governmentwide financial statements, we reviewed the compilation of the inventory<sup>1</sup> line item included in the Department of the Navy's fiscal year 1999 Principal Financial Statements, which report general fund operations.<sup>2</sup> Inventory reported by the general fund consists primarily of operating materials and supplies, which includes sponsor owned material,<sup>3</sup> ammunition, contractor held material, and other classifications of inventory.

The Navy does not have central reporting of general fund inventory, and the systems used to maintain accountability over inventory are not integrated with core accounting systems. Therefore, the Navy relies on manual "data calls" to compile inventory data for financial reporting. To review the compilation of the inventory line item, we reviewed the Navy information obtained through the data call process to evaluate the completeness and accuracy of reported inventory and to determine whether inventory was properly classified. However, because of the lack of system integration and central inventory management, it is not possible to ensure that all inventory owned by the Navy is identified through the data call process or

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<sup>1</sup>Federal accounting standards define inventory as tangible personal property that is held for sale, operating materials and supplies consumed in normal operations, and stockpile materials held due to statutory requirements for use in national defense.

<sup>2</sup>General fund activities are funded by direct appropriations. In contrast, other Navy activities are funded by working capital funds, which are revolving funds used as a source of financing for supplies and services that will be paid for by the customer.

<sup>3</sup>Sponsor owned materials are items purchased, held, and managed by Navy program managers to support mission requirements for the production, life-cycle maintenance, and installation of weapon systems.

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GAO-01-37R Navy's Inventory Reporting

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by our review. As we have previously testified,<sup>4</sup> deficient logistics systems continue to impair the Navy's ability to both effectively maintain visibility and prepare reliable financial reports for these assets. Over the long-term, the Navy will need to develop and implement integrated financial and logistical systems to provide for accurate financial reporting and improved visibility.

We noted that the Navy has acted on a number of past audit recommendations to improve financial reporting. For example, the Navy reported four classes of inventory this year that were not reported previously. The newly reported categories included sponsor owned material of \$5.5 billion, residual assets<sup>5</sup> of \$584 million, Navy material held by the Coast Guard of \$101 million, and contractor held material of \$11.3 billion.<sup>6</sup> The inclusion of these items, plus other changes, tripled the Navy's reported inventory value from the previous fiscal year.

Although these changes improved the Department of the Navy's financial reporting, we identified a number of errors and omissions in the financial statements that continue to affect the reporting of inventory. These problems included (1) sponsor owned material was not accurately reported, (2) ammunition reported was not properly valued and not all ammunition was reported, (3) property in the possession of contractors was not properly classified, and (4) certain shipboard materials were not reported. This letter summarizes our findings so that the Navy can address these issues as it compiles its fiscal year 2000 financial information and to ensure that the Navy considers these issues as it moves towards its long-term solution of integrated systems.

#### **Sponsor Owned Material Not Accurately Reported**

The Navy reported \$5.5 billion of sponsor owned material. We traced the value reported in the financial statements to supporting data. As discussed earlier, the Navy used a manual "data call" process to compile data for financial statement reporting because current systems cannot provide consolidated reporting of inventory on hand. We found that the financial statements did not always match the information submitted by commands that hold this inventory. For example, the Naval Sea Systems Command (NAVSEA) submitted a figure of \$3.2 billion for sponsor owned material, but the amount used for financial statement compilation was \$2.9 billion—a difference of \$300 million. NAVSEA officials confirmed that \$3.2 billion should have been reported. Navy officials stated that the 1999 beginning inventory value of \$2.9 billion was reported in error as the 1999 ending inventory amount. The error resulted from a lack of familiarity with the data call document, according to Navy officials.

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<sup>4</sup>*Department of Defense: Progress in Financial Management Reform* (GAO/T-AIMD/NSIAD-00-163, May 9, 2000).

<sup>5</sup>Residual assets are excess items stored at redistribution sites as ships are decommissioned or overhauled. This material is redistributed free of charge from these sites.

<sup>6</sup>Contractor held material was incorrectly reported as property, plant, and equipment (PP&E) in 1998.

Additionally, the Naval Audit Service reported<sup>7</sup> that the Naval Air Systems Command could only estimate a value for its sponsor owned inventory because it did not have a system in place to capture and report this material. Its estimate of \$2 billion represented over a third of the \$5.5 billion of sponsor owned material reported. Further, Navy personnel were unable to provide support for the estimate.

### **Ammunition Not Properly Valued and Not Completely Reported**

Our review of ammunition reported identified a number of errors, omissions, or instances of noncompliance with financial accounting standards.

- The Navy did not report air-launched guided missile support items or NAVSEA ASROC (anti-submarine rocket) material.<sup>8</sup> The value of these items at September 30, 1999, according to inventory records, was \$7.8 million and \$41.6 million, respectively. Officials said that this was an unintentional omission.
- Ammunition items needing repair, including the unserviceable items discussed below, were not separately identified or revalued to reflect the estimated cost of repair. The full value of items needing repair, according to inventory records, was \$1.4 billion for the four ammunition categories that the Navy reported for fiscal year 1999.<sup>9</sup> Federal accounting standards require that inventory values be reduced for estimated repair costs for financial reporting. Navy officials stated that the ammunition items needing repair were not revalued in accordance with federal accounting standards because Department of Defense (DOD) regulations<sup>10</sup> require ammunition to be reported at full cost, without a provision for reducing the value for estimated repair costs. However, these regulations refer only to the reporting of ammunition on the Supply System Inventory Report (SSIR),<sup>11</sup> not to financial statement reporting. As a result, the on-hand ammunition balance was overstated. This failure to revalue ammunition in need of repair was also reported by the Naval Audit Service in its report on its audit of the Department of the Navy's fiscal year 1998 financial statements.<sup>12</sup>
- The Navy did not completely classify, revalue, and report its excess, obsolete, and unserviceable inventory. Statement of Federal Financial Accounting Standard (SFFAS) No. 3, *Accounting for Inventory and Related Property*, defines excess inventory as stock

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<sup>7</sup>*Department of the Navy Principal Statements for Fiscal Year 1999: Inventory and Related Property, Net* (NAS report no. N2000-0023, May 15, 2000).

<sup>8</sup>The Navy groups its inventory and related property into categories based upon the type of material and the organization that manages the material. These groupings are called cognizance codes or simply COGs. The air-launched guided missile support items discussed here are 4E COG items, and the ASROC material is designated 8S COG.

<sup>9</sup>The 4E and 8S COGs are not included in this figure because they were not reported in 1999, as noted above.

<sup>10</sup>*Department of Defense Materiel Management Regulation* (DOD 4140.1-R), May 1998.

<sup>11</sup>The SSIR is an annual DOD inventory report to the Congress that has specific regulations on its presentation.

<sup>12</sup>*Department of the Navy Principal Statements for Fiscal Year 1998: Inventory and Related Property, Net* (NAS report no. 98-0004, March 31, 1999).

that exceeds the demand expected in the normal course of operations; obsolete inventory as inventory that is no longer needed due to changes in technology, laws, customs, or operations; and unserviceable inventory as damaged inventory that is more economical to dispose of than to repair. SFFAS No. 3 and the *Department of Defense Financial Management Regulation* (DOD 7000.14-R, volume 4, chapter 4) require that excess, obsolete, or unserviceable inventory be reported at its estimated net realizable value.

Excess - The Navy reported only excess items in the "Excess, Obsolete, and Unserviceable" category of materials. Further, for the excess ammunition reported for fiscal year 1999, the Navy did not revalue it to net realizable value in accordance with federal accounting standards and the DOD *Financial Management Regulation*. Navy officials stated that the excess ammunition was not revalued because DOD regulations<sup>13</sup> require ammunition to be reported at full cost, without a provision for revaluing excess, obsolete, and unserviceable items to net realizable value. As stated previously, the regulations cited by Navy officials refer only to the reporting of ammunition on the SSIR, and not to financial statement reporting. As a result, the value of the on-hand balance was overstated.

Obsolete - Obsolete ammunition was not reported in the fiscal 1999 financial statements. Navy officials could not explain why obsolete ammunition items were not reported. In 1998, inventory records indicated that obsolete ammunition was \$202 million.

Unserviceable - The Navy did not identify and revalue unserviceable ammunition items, but rather reported all ammunition in need of repair, including unserviceable items, at full value. As noted previously, this resulted in overstating the on-hand balance.

#### **Property in the Possession of Contractors Not Properly Classified**

As previously noted, the Navy properly reclassified its contractor held material—comprised of property in the possession of contractors, government furnished material, and contractor acquired material—to the inventory line item for fiscal year 1999. The value of that material totaled a reported \$11.3 billion. However, Navy officials indicated that items reported as property in the possession of contractors included some items already installed on ships during construction or repair. The installed items should not be classified as inventory but rather accounted for as part of the ship. As a result, the inventory line item was overstated by the value of installed items included as property in the possession of contractors. The value of this misclassification has not been determined.

Problems classifying inventory and other property in the possession of contractors are not limited to the Navy. The Under Secretary of Defense (Comptroller) has asked the Defense Contract Audit Agency (DCAA) to review the valuation and classification of property or material in the possession of contractors. This review includes the classification and value of materials (operating materials and supplies and inventory) in the possession of contractors, including materials that have already entered the repair or production process but are still reported as property in the possession of contractors. DCAA expects to issue a report on its assessments and conclusions in early fiscal year 2001.

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<sup>13</sup> *Department of Defense Materiel Management Regulation* (DOD 4140.1-R), May 1998.

### **Certain Shipboard Materials Not Reported**

The Navy continued to exclude inventory aboard some of its ships<sup>14</sup> from its reporting of operating materials and supplies. Such treatment is not consistent with federal accounting standards. According to SFFAS No.3, an end user is any component of a reporting entity that obtains goods for direct use in the component's normal operations. However, SFFAS No. 3 goes on to state that any component of a reporting entity that maintains or stocks operating materials and supplies for future issuance shall not be considered an end user.

In 1996, we first reported<sup>15</sup> that shipboard inventories were omitted from the Navy's financial statement reporting. Since that time, the Navy has changed the categories of inventories in its financial reporting to include supplies aboard aircraft carriers and other large vessels as working capital fund items held for sale. With this change in reporting, the Navy has acknowledged that inventories maintained at storage locations onboard its large ships that are available for future issuance are not yet in the hands of end users and therefore represent reportable operating materials and supplies in accordance with SFFAS No. 3. The Navy, though, has continued to take the position that shipboard inventories held for future use aboard smaller combatant ships should be considered in the hands of the end user and therefore should not be reported. However, we continue to maintain that, like inventories held in supply on the Navy's large vessels, these smaller combatant ships also have central supply functions that maintain inventories held for future issuance to operating units throughout the ship. Consequently, these smaller combatant ship inventories, like those on its large vessels, are not yet in the hands of end users and therefore should be reported as operating materials and supplies.

The Naval Audit Service previously reported that the value of these excluded shipboard operating materials and supplies was \$9.4 billion as of September 30, 1998. We have previously reported that this issue affects not only financial reporting but asset visibility as well. Specifically, we reported<sup>16</sup> that the lack of Navy-wide visibility over shipboard inventories substantially increased the risk that the Navy may request funds to obtain additional unnecessary inventories because responsible managers did not receive information that excess inventories were already on hand in other locations.

### **Conclusions**

The Navy has made several improvements in identifying and reporting its inventory. However, errors in the compilation and reporting of those assets continue to affect the reliability of the Navy's financial reports. Additionally, some policy issues, such as the revaluation of ammunition and the reporting of shipboard inventories held for future use,

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<sup>14</sup>The excluded inventory was for smaller combatant ships such as cruisers, frigates, destroyers, and submarines.

<sup>15</sup>See *Navy Financial Management: Improved Management of Operating Materials and Supplies Could Yield Significant Savings* (GAO/AIMD-96-94, August 16, 1996).

<sup>16</sup>*CFO Act Financial Audits: Programmatic and Budgetary Implications of Navy Financial Data Deficiencies* (GAO/AIMD-98-56, March 16, 1998).

need to be resolved to reflect current federal accounting standards and DOD regulations as the Navy moves forward in its efforts to produce complete and reliable financial statements.

We are making recommendations to improve, to the extent practical, the current manual, noncentralized process used to compile the Navy's inventory data. However, these measures, while vital in the short term, can only be considered interim steps to improve data accuracy, given the accountability and financial reporting limitations inherent in the current process. The ultimate, longer term solution to providing accurate financial reporting and improved visibility will require the development and implementation of integrated financial and logistical systems.

### **Recommendations for Executive Action**

We recommend that you take the following actions to correct the types of errors and omissions that we identified in the compilation of the Navy's inventory information.

- Develop a review process so that data call information on sponsor owned material is correctly reported.
- Document the basis of any estimates of sponsor owned material to facilitate managerial reporting and auditor review.
- Develop a review process for ammunition reporting so that all types of ammunition are included in the Navy's financial reports, including air-launched guided missile support items and anti-submarine rocket material.
- Properly classify and disclose ammunition in the "excess, obsolete, and unserviceable" categories in accordance with SFFAS No. 3.
- Review the reporting of contractor held material to determine what portion of the \$11.3 billion reported should not be classified as inventory and determine proper financial statement classification. This should include coordination with the DOD-wide DCAA project that is reviewing property in the possession of contractors.

In addition, we recommend that you revise the Navy's policies for compiling its financial statements so that they are in accordance with federal accounting standards and the DOD *Financial Management Regulation*. Specifically, (1) ammunition items needing repair and those categorized as excess, obsolete, and unserviceable should be revalued appropriately to comply with SFFAS No. 3 and the DOD *Financial Management Regulation* and (2) shipboard inventories aboard smaller combatant ships should be reported as operating materials and supplies in accordance with federal accounting standards.

Finally, you should consider the issues discussed in this letter in the development and implementation of the long-term systems solution for proper accounting and improved visibility of the Navy's inventory.

### **Agency Comments and Our Evaluation**

We requested comments on a draft of this report from the Secretary of Defense or his designee. On October 19, 2000, the Principal Deputy, Assistant Secretary of the Navy

(Financial Management and Comptroller) provided us with comments, which are reprinted in the enclosure. DOD concurred with our recommendations and stated that the Department of the Navy remains committed to producing consistent, timely, useful, and complete data and information for its managers to use in making decisions and processing financial reports. We are pleased that the Navy is working to reduce the number of systems used to account for operating materials and supplies through standardization and consolidation and to ensure that those remaining systems meet federal accounting standards.

The DOD response also stated that the treatment of Navy shipboard inventories aboard smaller combatant ships remains a reporting issue to be resolved by the Navy's Operating Materials and Supplies Working Group in coordination with the DOD Office of the Comptroller. We agree and have clarified our position as discussed in this letter. We reiterate our long-held position that until these items are in the hands of the end users, they should be reported as operating materials and supplies in accordance with federal accounting standards.

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We would appreciate a written response within 60 days of the date of this letter on actions you have taken or plan to take to address our recommendations.

Copies of this letter are being sent to Nelson Toye, Deputy Chief Financial Officer, Office of the Under Secretary of Defense (Comptroller), and to interested congressional committees. Copies will be made available to others upon request. If you have further questions regarding these findings, please contact Geoffrey B. Frank, Assistant Director, at (202) 512-9518 or me at (202) 512-9095. Key contributors to this assignment were William Cordrey and Lisa Warde.

Sincerely yours,



Lisa G. Jacobson  
Director  
Financial Management and Assurance

Enclosure

Enclosure

**Comments From the Department of the Navy**



**DEPARTMENT OF THE NAVY  
OFFICE OF THE ASSISTANT SECRETARY  
(FINANCIAL MANAGEMENT AND COMPTROLLER)  
1000 NAVY PENTAGON  
WASHINGTON, D.C. 20350-1000**

OCT 19 2000

Mr. Jeffrey C. Steinhoff  
Assistant Comptroller General  
Accounting and Information Management Division  
U.S. General Accounting Office  
Washington, DC 20548

Dear Mr. Steinhoff:

We have reviewed the General Accounting Office draft report, "Financial Management: Improvements Needed in the Navy's Reporting of General Fund Inventory," of September 25, 2000 (GAO Code 919527/OSD Case 2091) that you provided to the Secretary of Defense on September 25, 2000. The enclosure provides the Department of the Navy's comments to the recommendations of the draft report.

Your recommendations focus on issues that we are currently working to resolve regarding General Fund Inventory, Operating Materials and Supplies. Some issues can be resolved immediately while others will take longer. The Department of the Navy's Operating Materials and Supplies Working Group, which includes members of the General Accounting Office's audit community has made significant progress over the past fiscal year in identifying operating materials and supplies assets and systems. The group is also working to reduce the number of systems through standardization and consolidation and to ensure that those remaining systems meet federal accounting standards.

The Department of the Navy remains committed to producing consistent, timely, useful, and complete data and information for our managers to use in making decisions and for processing financial reports.

Sincerely,

**GLADYS J. COMMONS  
Principal Deputy  
Assistant Secretary of the Navy  
(Financial Management and Comptroller)**

Enclosure

GAO DRAFT REPORT DATED SEPTEMBER 25, 2000  
(GAO CODE 919527) OSD CASE 2091

"FINANCIAL MANAGEMENT: IMPROVEMENTS NEEDED  
IN THE NAVY'S REPORTING OF GENERAL FUND  
INVENTORY"

DEPARTMENT OF NAVY COMMENTS  
TO GAO RECOMMENDATIONS

The GAO made the following 6 recommendations to the Assistant Secretary of the Navy (Financial Management and Comptroller):

**RECOMMENDATION 1:** Develop a review process so that data call information on sponsor owned material is correctly reported.

**DON RESPONSE:** Concur. The ASN(FM&C) staff has been meeting with the Operating Materials and Supplies Working Group (OM&SWG) and other groups throughout FY 2000 to discuss data collection requirements, processes and procedures. These actions should mitigate errors in reporting non-financial feeder system data and information for the financial statements.

**RECOMMENDATION 2:** Document the basis of any estimates of sponsor owned material to facilitate managerial reporting and auditor review.

**DON RESPONSE:** Concur. The Under Secretary of Defense (Comptroller), in conjunction with the General Accounting Office (GAO), and the Office of Management and Budget, developed a series of "Implementation Strategies" to improve the financial statements of the Department of Defense and achieve an unqualified audit opinion. Under the leadership of the Deputy Under Secretary of the Navy (Institutional Strategic Planning) (DUSN(ISP)), the DON established a number of teams to execute the milestones identified in each strategy. The Operating Materials and Supplies Working Group (OM&SWG) was established in response to the DoD Implementation Strategy (B.2., Operating Materials and Supplies). The team is chaired by senior DON leadership and includes staff from the financial, functional, and audit communities. Throughout FY 2000, the OM&SWG has been working on identifying all OM&S assets, identifying all OM&S systems, reducing the number of systems through standardization and consolidation, and ensuring the remaining systems meet federal accounting standards for OM&S. In addition, the FY 2000 DON General Fund data call requires that the responsible official for each of the categories reported, including sponsored owner material, maintain supporting detailed files or records for reference purposes. This fact is presented at the beginning of each section of the data call.

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**RECOMMENDATION 3:** Develop a review process for ammunition reporting so that all types of ammunition are included in the Navy financial reports, including air-launched guided missile support items and anti-submarine rocket material.

**DON RESPONSE:** Concur. At the September 2000 meeting the OM&SWG discussed the definition of Appropriation Purchases Account Principal Items which include those assets mentioned in the recommendation and concluded that those items should be reported on the FY 2000 DON financial statements. The FY 2000 DON General Fund data call included the requirement for reporting those items discussed in the recommendation.

**RECOMMENDATION 4.** Properly classify and disclose ammunition in the excess, obsolete, and unserviceable categories in accordance with SFFAS No. 3.

**DON RESPONSE.** Concur. The Conventional Ammunition Integrated Management System (CAIMS) does not meet all the requirements of the Statement of Federal Financial Accounting Standards (SFFAS) No. 3, particularly regarding valuation at historical cost. Conflicts in policy and guidance in the Department of Defense Financial Management Regulation (DoD 7000.14-R) and the DoD Material Management Regulation (DoD 4140.1-R) for the valuation of ammunition precludes the Naval Ammunition Logistics Center (NALC) from incorporating system changes into CAIMS to meet the requirements of the SFFAS No. 3. By ASN(FM&C) memorandum of 12 July 2000, the Under Secretary of Defense (Comptroller) (USD(C)) was requested to provide specific resolution to the conflicting policy and guidance in the DoD regulations. USD(C) memorandum of 9 August 2000 stated that resolution to the conflicting DoD regulations is under way. To remain proactive, NALC has begun the analysis and cost benefit identification of making CAIMS compliant with Federal accounting standards. Evaluation is currently underway to draft the appropriate business rules for meeting the cost flow assumptions of the SFFAS No. 3.

**RECOMMENDATION 5:** Review the reporting of contractor held material to determine what portion of the \$11.3 billion reported should not be classified as inventory, and determine proper financial statement classification. This should include coordination with the DoD-wide DCAA project that is reviewing property in the possession of contractors.

**DON RESPONSE:** Concur. The DON Government Property in Possession of Contractors (GPPC) Working Group is currently reviewing the process and procedures for reporting government furnished material. During FY 2000, DoD Implementation Strategy A.3,

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"Property in the Possession of Contractors" was revised to utilize the Defense Contract Audit Agency (DCAA) to initiate a review of not only property but government furnished material (GFM). The DON has participated in the oversight committee that is managing the DCAA study. The DCAA study will determine whether GFM should be categorized as (1) material incorporated into the end product or consumed in the production of items for the contract; (2) material consumed in a repair process or material sent to a contractor for repair; or (3) material managed or stored for a DoD component. The DCAA study on government furnished material should be completed by mid October 2000. The DON GPPC Working Group will incorporate the results of the DCAA study into their plan of action for resolving the reporting issue of government furnished material in the possession of contractors.

**RECOMMENDATION 6:** Revise the Navy's policies for compiling its financial statements so that they are in accordance with federal accounting standards and the DoD Financial Management Regulation. Specifically, (1) ammunition items needing repair and those categorized as excess, obsolete, and unserviceable, should be revalued appropriately to comply with SFFAS No. 3 and the DoD Financial Management Regulation; and (2) shipboard inventories, aboard smaller combatant ships, should be reported as operating materials and supplies, in accordance with federal accounting definitions.

**DON RESPONSE:** Concur. (1) The Conventional Ammunition Integrated Management System (CAIMS) does not meet all the requirements of the Statement of Federal Financial Accounting Standards (SFFAS) No. 3, particularly regarding valuation at historical cost. Conflicts in policy and guidance in the Department of Defense Financial Management Regulation (DoD 7000.14-R) and the DoD Material Management Regulation (DoD 4140.1-R) for the valuation of ammunition precludes the Naval Ammunition Logistics Center (NALC) from incorporating system changes into CAIMS to meet the requirements of the SFFAS No. 3. By ASN(FM&C) memorandum of 12 July 2000, the Under Secretary of Defense (Comptroller) (USD(C)) was requested to provide specific resolution to the conflicting policy and guidance in the DoD regulations. USD(C) memorandum of 9 August 2000 stated that resolution to the conflicting DoD regulations is under way. To remain proactive, NALC has begun the analysis and cost benefit identification of making CAIMS compliant with Federal accounting standards. Evaluation is currently underway to draft the appropriate business rules for meeting the cost flow assumptions of the SFFAS No. 3. (2) By SFFAS No. 3, an end-user is an entity that obtains assets for direct use in that entity's normal operations. The DON position has been that shipboard inventories, aboard smaller combatant ships is an engineered

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estimate of what that ship needs to be able to perform its mission and therefore is considered in the hands of the end-user. These shipboard inventories are purchased from the supply system by the ship based upon predicted operational needs of that ship. The operational needs of the ship are identified in documents called Coordinated Shipboard Allowance Lists (COSALs). Once purchased from the supply system, the asset is available only for the operational needs of that ship. Only in extreme cases (other ships experiencing severe operational conditions) will these assets be used outside the ship's needs. Therefore, the DON has not been reporting the value as OM&S on the DON Balance Sheet but rather as expenses on the Statement of Net Cost. However, the DON OM&SWG which includes representatives from GAO, Department of Defense Inspector General, and the Naval Audit Service has recognized shipboard inventories aboard smaller combatant ships as a reporting issue and is working with USD(C) to come to resolution on the issue.

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